



# NEWSLETTER

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## GST Increase

GST is set to increase from 12.5% to 15% on 1 October 2010. As the transition date has drawn closer, businesses around the country have been working on the issues that will be faced. One key consideration will be whether their accounting systems will be able to cater for multiple rates simultaneously while producing technically accurate GST returns, invoices, credit notes and debit notes. In some cases businesses have found that 'grey areas' exist under the GST legislation or that their existing practices are not technically correct, or both.



The time of supply for a transaction is important in a GST context as it determines the rate that will apply, i.e. if a supply takes place prior to 1 October 2010 the 12.5% rate will apply. By default, the time of supply is the earlier of an invoice being issued or any payment being received by the supplier. One potential 'grey area' involves the sale of land. For example, a sale and purchase agreement is executed on 15 September 2010, the agreement becomes unconditional on 15 October 2010 at which time a 10% deposit is paid. Assuming no invoice has been issued prior to 15 October the payment of the deposit is likely to trigger the default time of supply rule (assuming there is no specific provision for the deposit to be held in a stakeholder capacity) and the rate of 15% will apply to the sale. This scenario could be interpreted incorrectly if people assume the execution of the contract will allow the lower rate of 12.5% to apply.

In specific scenarios the default time of supply rule is altered. This is the case where, for example, goods or services are supplied or paid for over a period of time. The time of supply for construction contracts, for example, is spread over the term of a contract based on the earlier of an invoice being issued, or a payment being due or received. In some cases it can be unclear if a particular contract falls under this timing rule or the default timing rule.

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Another area of uncertainty relates to the supply of services by periodic payment, such as telephone contracts, internet, sports memberships etc. In this type of situation, the time of supply is the earlier of when a payment is due or paid. Consider a supply of a service provided in August, which is invoiced in September, but payment is not due until October. The rate of 15% would apply to a service made to a customer two months prior to the rate changing, an outcome the customer is unlikely to expect. To avoid customer complaints a service provider could pay the additional GST from their own margin.

The Government and IRD have acknowledged uncertainty exists and formed the GST advisory panel to

consider the issues and recommend solutions, whether by policy initiatives or legislative change. A website has been launched at [www.gstadvisory.govt.nz](http://www.gstadvisory.govt.nz) and members of the public are encouraged to send submissions outlining issues they are encountering.

Realistically speaking, some businesses are likely to take a pragmatic approach and get their systems and GST returns as close as possible to being correct and move on. The cost to achieve perfection could be considerable, when compared to the cost of getting it wrong. A reasonable approach should be expected by the IRD, given the one-off nature of the change and the cost being imposed on business to employ a change in the law imposed by the Government.

## IRD v Penny and Hooper - Round 3

The Court of Appeal recently considered whether the re-structuring of a medical practice and the payment of a commercially unrealistic salary amounted to tax avoidance, as claimed by the IRD. The Court found in favour of the IRD.



Mr Penny and Mr Hooper, both orthopaedic surgeons, initially operated their medical practices in their personal capacity. They re-structured their businesses to operate through companies that were substantially owned by their family trusts. The companies employed them for a salary that was less than what they earned

prior to the re-structure. The salary was also less than what they could have earned if they were employed on an arms-length basis by a third party.

The Court of Appeal decision overturns the previous ruling of the High Court where it was held the arrangement was not tax avoidance. The High Court had found:

- The use of a commercially orthodox business structure, such as a company, meant there was no need to justify the choice of one structure over another, and
- There was nothing in the Income Tax Act that supports the notion that the payment of a commercially realistic salary is an over-riding requirement.

The Court of Appeal Judges (two in support, one dissenting) found that the level of salary paid was so far removed from commercial reality as to be contrived and artificial. The adoption of the company/trust structure allowed the taxpayers to continue to enjoy the full benefit of their income but with substantially lower tax burdens, an outcome that would not have been within the contemplation of Parliament when drafting the law.

The Court of Appeal decision has significant implications for many New Zealanders, particularly those employed by a company that they or their family have ownership or control over.

The Judge acknowledged that this decision would create uncertainty, and explicitly noted that the decision should not be construed as saying that a less than market salary is to be automatically regarded as meaning tax avoidance.

More recently it has been announced Penny and Hooper are appealing the decision to the Supreme Court. Meanwhile, the decision reflects current law and will be applied by the IRD.

In light of the far reaching significance of this decision there has been considerable media and IRD comment and the IRD has released a Revenue Alert (*RA 10/01*) detailing the IRD's approach for its application.

The Alert indicates that there is a wide range of factors the IRD would consider when analysing a structure to determine if it amounts to tax avoidance, and a salary that does not reflect a person's contribution to profits is an "important indicator (though not conclusive on its own)". The Alert further provides that the IRD would not expect remuneration to be paid where there is little or no profit being generated by the operating structure, such as during start-up or difficult trading conditions.

Although the IRD Alert provides a basis on which to review a structure and a person's salary, it does not provide prescriptive thresholds on how the IRD will approach the issue. This is understandable given that every situation is different and has to be determined based on its own facts. Consequently this leads to uncertainty around how the IRD will consider the issue in practice and whether the IRD's stance will vary across the country.

## Shareholders' Agreement – Why have one?

A large proportion of New Zealand businesses are operated through companies that are small and closely held. It is also common that many of these companies are owned and operated by families, with no involvement by "third parties". As these companies are family-owned and operated, there tend to be few issues that cannot be resolved through family discussion.

In companies that are owned and operated by persons who are unrelated to each other, disputes or other issues may arise where there is no "family relationship" to fall back on to reach a resolution. For companies like this, it is imperative that there is a mechanism established from the outset to overcome any hurdles that may arise. The shareholders' agreement provides such a mechanism.



### What is a Shareholders' Agreement?

A shareholders' agreement is a legally binding agreement between the shareholders of a company, which sets out rules or procedures relating to that company. These rules and procedures can span a wide range of matters and situations. Unlike a company's constitution, which is publicly accessible, a shareholders' agreement is confidential between the shareholders of the company. Therefore, it is often preferable for some matters to be dealt with in a shareholders' agreement rather than the constitution. To ensure that the shareholders' agreement takes precedence over the constitution, it is usual to state in the constitution that where there are conflicts between the constitution and the shareholders' agreement, the shareholders' agreement will prevail.

### What does a Shareholders' Agreement Typically Cover?

While there is no prescribed format or list of inclusions for a shareholders' agreement, there are a number of

matters that would usually be included, for example:

- management and control of the company, including the right to appoint and remove directors,
- the right to vote and the matters that require unanimous or majority decisions,
- the process for entry and exit of shareholders,
- dividend policy,
- capital and funding structure,
- dispute resolution.

### Disputes and Deadlocks

Apart from establishing the processes and mechanisms for managing and operating the company, two very important reasons for having a shareholders' agreement are to:

- Provide resolution when there are shareholder disputes. While shareholders might hope to always be able to reach an agreement with each other, unfortunately shareholders' disputes are all too common. If there is no shareholders' agreement the process of resolving such disputes can be messy, expensive and extremely distracting from the day-to-day operations of the company.
- Provide a process to resolve deadlocks. Deadlocks occur when shareholders holding equal voting rights are unable to agree. A "deadlock provision" will set out a mechanism by which deadlocks can be resolved and enable the company to move forward.

A shareholders' agreement is often overlooked because legally a company constitution is all that is required. However, a shareholders' agreement can prove invaluable down the track. To adopt a shareholders' agreement the first point of contact should be a professional advisor, who can help you to determine what needs to be included in the agreement. While there is an initial expense upfront in professional fees, the avoidance of pain later is worth the investment if things don't quite go to plan.

## Charities Commission gets Tough

The enactment of the Charities Act 2005 led to the formation of the Charities Commission on 1 July 2005. The purpose of the Commission is broadly to monitor, promote and educate charitable entities to ensure that charities are exercising good governance and compliance.

The Commission, amongst other things, is responsible for receiving applications from organisations wishing to register as charities and monitoring the Register to ensure that registered organisations continue to fit the criteria for registration.

In order for an organisation to qualify for registration with the Commission it must have a charitable purpose. The definition of "charitable purpose" as prescribed by the Charities Act 2005 includes every charitable purpose, whether it relates to:

- the relief of poverty,
- advancement of education,
- advancement of religion, or
- any other matter that is beneficial to the community.

Registration with the Commission allows an organisation to qualify for income tax exempt status (subject to restrictions if its purpose is partly carried on outside New Zealand). Prior to the Act coming into force, there was no requirement under the Income Tax Act for an organisation to apply for income tax exempt status.



Currently, if an organisation is approved as charitable and its charitable purpose is carried on in New Zealand, the IRD is advised and the organisation will generally be granted donee status. Obtaining donee status is beneficial to charities as it enables people who make donations to qualify for a tax rebate, and donations are a major source of funding for most charitable organisations. A common misconception is that charitable status is required for donee status. An organisation, depending on its purpose, can obtain donee status even though it is not a registered charity. Practically speaking however, charitable status is preferred as it simplifies tax obligations and provides a stronger incentive to the public to make donations.

Recently the Commission has ruled that some well known organisations are not charitable. The yachting syndicate Team New Zealand and the Freemasons movement have been denied registration on the grounds that they exist mainly for their own benefit, and therefore do not qualify. Other groups such as the National Council of Women, Greenpeace and the Sensible Sentencing Trust have been pronounced 'advocacy' groups rather than charities, and therefore do not qualify.

## Snippets

### R&D Vouchers

The research, science and technology sector received an allocation of \$321 million in the 2010 Budget to help establish high-performing public science systems, designed to encourage increased investment into research and development.



Of the funding, \$20 million has been allocated to a Government trial of "technology transfer vouchers". The vouchers are to be made available to businesses that do not have a strong research and development capability. The vouchers, worth between \$100,000 and \$1 million, would be redeemable at public research institutions and enable a business to fund up to 50% of a research and development project. The research project would have to have a wider benefit than to the business itself. The intention is for businesses to benefit from partnering with a public research organisation to benefit from the specialist skills the research organisation could provide.

Similar schemes have been used throughout the UK, Europe and Canada, with great success.

These recent actions by the Commission may seem like the rules have been tightened, when in fact the Commission is enforcing common law principles developed over the past 400 years.

The Courts have previously determined that a political purpose is not charitable. This is based on the principle that the law is right as it stands and has been enacted for the benefit of the public. Therefore, those seeking to change the law are, strictly speaking, not acting for the benefit of the public. The Commission's chief executive, Trevor Garrett, said that organisations that dabbled in political advocacy but which were primarily community-focused, such as the Plunket Society, were safe from being removed from the Register. This type of entity essentially has a primary purpose that is charitable, with some auxiliary activities that are not.

What can be considered charitable evolves over time as the views of society and the needs of the community change. The current actions of the Charities Commission may lead to a further evolution by New Zealand's Courts.

By its actions, the Commission has made it clear they are going to enforce the charitable purpose test, and weed out the organisations that are not, strictly speaking, charitable. Whether or not this will always be beneficial to the community remains to be seen.

### The Future of Gift Duty

In a statement issued by Hon. Peter Dunne, the possible repeal of gift duty has been signalled. Gift duty was originally introduced to prevent people from avoiding estate duty. When estate duty was removed in 1992, gift duty was left in place to stop people from re-distributing their assets to avoid creditors, reduce their tax liability and/or acquire social assistance. Currently, individuals can gift up to \$27,000 per year without incurring gift duty.



It is common practice to make gifts that do not exceed the \$27,000 threshold; therefore very little gift duty is ever collected, but significant administration costs are incurred. Concerns still exist over the use of gifting to undermine the interests of creditors or to access social assistance, but the Government is in the process of considering if other measures could be used to overcome these concerns if gift duty were to be repealed.

*If you have any questions about the newsletter items, please contact us, we are here to help*